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4

5 UNITED STATES BANKRUPTCY COURT  
6 WESTERN DISTRICT OF WASHINGTON  
AT SEATTLE

7 In re )  
8 ) Chapter 13  
DIANE EVANS, )  
9 ) Bankruptcy No. 04-12661  
10 Debtor. )  
11 )  
In re ) Chapter 13  
12 ) Bankruptcy No. 03-24162  
REBECCA I. VALDIVIA, )  
13 ) **MEMORANDUM DECISION**  
14 Debtor. ) **ON STUDENT LOANS AND**  
**COLLECTION CHARGES**  
15 )

16 In these cases, the debtors challenge proofs of claim filed  
17 by Educational Credit Management Corporation ("ECMC") for student  
18 loan debt. In particular, the debtors have challenged ECMC's  
19 inclusion of collection costs in the claims, contending that the  
20 collection costs are unreasonable and that they constitute  
21 postpetition claims not allowable in their bankruptcy cases.  
22 Rebecca Valdivia also contends that her loans are eligible for  
23 rehabilitation, and that on that basis, any collection costs that  
24 are allowable against her must be limited to 18.5%. For the  
25 following reasons, the Court will deny the debtors' objections to  
26 the collection charges, but the Court agrees that in the case of  
27 Ms. Valdivia, those charges may be limited to 18.5%.

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1                                   **I.    PROCEDURAL BACKGROUND**

2           The debtors' objections to ECMC's claims initially came  
3 before the Court for hearing on September 15, 2005. At that  
4 time, it became clear that both debtors were making the same  
5 challenge to the collection costs imposed by ECMC on their unpaid  
6 educational loan debts. For efficiency, the Court set an  
7 evidentiary hearing on both cases for the same date so that three  
8 remaining issues could be determined: (i) whether ECMC's  
9 imposition of collection charges constitutes an improper  
10 postpetition collection activity; (ii) whether the collection  
11 charges assessed violate the terms of the debtors' student loan  
12 notes; and (iii) whether the amounts sought are otherwise  
13 unenforceable against the debtors under Bankruptcy Code  
14 § 502(b)(1).<sup>1</sup> Separately, Ms. Valdivia claimed that she was  
15 entitled to reinstatement of her loans.

16           On December 16, 2004, the Court held an evidentiary hearing  
17 in both cases. The sole witness for ECMC was Daniel Fisher, a  
18 managing attorney for ECMC. Mr. Fisher testified concerning the  
19 background of the student loan program and the process by which  
20 ECMC and other student loan agencies assess collection charges on  
21 defaulted student loans. Counsel for Ms. Evans and Ms. Valdivia  
22 cross examined Mr. Fisher. Ms. Valdivia, the only other witness,  
23 testified concerning her student loan and payment history. At  
24 the conclusion of the hearing, the Court requested additional  
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26           <sup>1</sup> Unless otherwise indicated, all Chapter, Section and Rule  
27 references are to the Bankruptcy Code, 11 U.S.C. §§ 101 *seq.* and  
28 to the Federal Rules of Bankruptcy Procedure, Rules 1001 *et seq.*

1 legislative history from ECMC. By letter dated December 21,  
2 2004, counsel for ECMC provided the Court with additional  
3 references to the legislative history to the relevant federal  
4 statutes and regulations. In addition, counsel for ECMC advised  
5 the Court of a decision by a United States District Court in the  
6 Southern District of Indiana, addressing issues identical to  
7 those under consideration in these cases. That decision,  
8 *Educational Credit Management Corp. v. Barnes*, 318 B.R. 482 (S.D.  
9 Ind. 2004), was issued on December 15, 2004. Counsel for ECMC  
10 also attached to his December 21, 2004 letter a copy of the  
11 deposition transcript of Pamela Moran, dated July 12, 2001, which  
12 was taken in the *Barnes* case. The Court has not considered that  
13 deposition, however, as it was not provided to the Court and the  
14 debtors prior to the evidentiary hearing on December 16, 2004.  
15 The Court then took the matter under advisement.

## 16 **II. FACTUAL BACKGROUND**

### 17 **A. Diane Evans Case.**

18 In the fall of 1993, Ms. Evans consolidated her existing  
19 student loans to create the single student loan at issue here  
20 (the "Evans Loan"). The total amount of the consolidated loan  
21 was \$14,800.54 with interest at 9% per annum. The Evans Loan was  
22 initially held by the Student Loan Finance Association ("Sallie  
23 Fae") and was serviced by Academic Financial Services Association  
24 ("AFSA"). After the loans were consolidated, but before the  
25 consolidated loan went into default, Ms. Evans made payments  
26 totaling \$455. All of these payments were applied to interest.

27 After a period of forbearance, Ms. Evans defaulted on the

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1 loan. On January 5, 1996, Northwest Educational Loan Association  
2 ("NELA") paid a claim to Sallie Fae/AFSA in the amount of  
3 \$15,865.43, and that amount then became the starting principal  
4 balance of the defaulted loan. Accrued and unpaid interest was  
5 capitalized as a result of the default and subsequent payment by  
6 the student loan guarantor.

7 From 1996 to the petition date in this case, Ms. Evans made  
8 payments totaling \$6,063.78. Of that amount, \$5,432.36 was  
9 applied to interest and \$631.42 was applied to collection costs.  
10 The payments, however, were never large enough or made frequently  
11 enough to result in any reduction to the principal balance of the  
12 loan. Exhibit 11 shows the payment history on the Evans Loan.  
13 NELA held the Evans Loan from January 5, 1996, the date of the  
14 default, through approximately August 22, 2003, when the  
15 Department of Education ("DOE") was subrogated to the rights of  
16 NELA. Ms. Evans' last payment on the loan was April 11, 2002,  
17 and that was a payment that resulted from a garnishment.

18 On March 1, 2004, Ms. Evans filed her Chapter 13 case. DOE  
19 held the Evans Loan as of the petition date, then assigned the  
20 loan to ECMC on April 14, 2004. ECMC timely filed a proof of  
21 claim for the amount owed on the Evans Loan as of the petition  
22 date. Ms. Evans filed a partial objection to the claim,  
23 asserting that the claim is overstated by the amount of the  
24 collection costs. The proof of claim states that the total  
25 balance as of the petition date was \$27,592.09, consisting of  
26 \$15,865.43 in principal, \$6,209.02 in interest, and \$5,517.84 in  
27 collection costs. The collection costs represent 34.77% of the

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1 principal balance and 25% of the amount of principal plus  
2 interest.

3 B. Rebecca Valdivia Case.

4 On June 15, 1996, Ms. Valdivia's student loans, which had a  
5 cumulative principal balance of approximately \$21,501 (the  
6 "Valdivia Loans"), entered repayment. The actual interest rates  
7 charged on each of the individual loans varied from year to year,  
8 but averaged approximately 7.5% during the entire life of the  
9 loans. Between June 15, 1996 and October 28, 1996, Ms. Valdivia  
10 applied for, and obtained, a forbearance on her loans,  
11 temporarily allowing her to forbear repayment, but not  
12 terminating the accrual of interest. At the end of the  
13 forbearance period, accrued interest in the total amount of  
14 approximately \$1,469 was capitalized, raising the principal  
15 amount of the loan to \$22,970.

16 On November 29, 1996, Ms. Valdivia made her first payment on  
17 her student loans in the amount of \$296. Only a small amount of  
18 this \$296 payment was applied to principal. The vast majority of  
19 the payment was applied to interest. During the life of the  
20 loans, this was the only payment large enough to permit any  
21 paydown of principal. Between November 29, 1996 and July 1,  
22 1997, Ms. Valdivia made no further payments on her loans, and the  
23 loans went into default.

24 On August 1, 1997, NELA (the guarantor on the Valdivia  
25 Loans) paid the claims to Sallie Mae. Because the loans were in  
26 default at the time, accrued interest was capitalized, resulting  
27 in a new principal balance of \$23,836. In addition, collection

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1 costs were applied to the Valdivia Loans at the same time.

2 On or about October 18, 2000, NELA advised Ms. Valdivia of  
3 her right to rehabilitate the defaulted loans by making twelve  
4 consecutive monthly payments. Ex. 18. Ms. Valdivia agreed to  
5 make monthly payments of \$250, commencing on October 28, 2000.  
6 The payments were set up to be automatically deducted from her  
7 checking account. The history of her payments is shown in  
8 Exhibit 7. At the conclusion of the twelve months of payments,  
9 Ms. Valdivia contacted NELA to determine what she needed to do  
10 next to rehabilitate her loans. She was told that she should  
11 have contacted NELA before the payments were completed, and that  
12 she would therefore have to make an additional twelve months of  
13 consecutive payments. Ms. Valdivia made another twelve  
14 consecutive monthly payments and in September of 2002, received  
15 an Acknowledgment of Debt for Rehabilitation of Defaulted Student  
16 Loans, Exhibit 19. Exhibit 19 informed Ms. Valdivia that if she  
17 signed the acknowledgment her loans would be sold by NELA to  
18 another lender and thereby removed from default status. The form  
19 further advised her that as a condition of the rehabilitation,  
20 she had to agree to the capitalization of all accrued interest  
21 and collection costs. The collection costs would be assessed at  
22 the rate of 18.5% of total principal and accrued interest.  
23 Interest at the note rates would then be charged going forward on  
24 the new principal balance. Because she objected to the  
25 collection costs that had been assessed, Ms. Valdivia never  
26 signed the acknowledgment required in Exhibit 19.

27 Between July 27, 1998 to October 31, 2003, Ms. Valdivia's

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1 payments totaled \$9,215. Of that amount, approximately \$7,635  
2 was applied to interest and \$1,573 was applied to collection  
3 costs. The payments were never high enough to result in any  
4 reduction to the principal balance of the loans.

5 On October 31, 2003, Ms. Valdivia filed her Chapter 13  
6 petition. As a result of the bankruptcy, NELA assigned the  
7 Valdivia Loans to ECMC. Upon the transfer of the loans, ECMC  
8 applied its own collection charges. ECMC timely filed two proofs  
9 of claim for amounts due under the Valdivia Loans as of the  
10 petition date. The total amount of the two claims is \$35,162.05,  
11 which includes principal of \$23,835.01, accrued interest of  
12 \$4,295.25, and collection charges of \$7,031.79. The collection  
13 charges represent 29.2% of the outstanding principal and 25% of  
14 the amount of principal plus interest.

15 Ms. Valdivia objected to the claims on the grounds that they  
16 were not sufficiently supported, that certain payments had not  
17 been properly applied, and that the claims included improper  
18 collection charges.

19 C. Collection Costs in Both Cases.

20 ECMC introduced no evidence of any specific collection  
21 action taken on either the Evans Loan or the Valdivia Loans by it  
22 or by any previous holders of the loans. It did, however, submit  
23 evidence of expenses incurred in collection activities in its  
24 national defaulted student loan portfolio. Exhibit 3 contains a  
25 list of the categories of expenses tracked by ECMC related to  
26 collection of defaulted student loans. These expenses, broken  
27 out by category, are shown for the twelve months of 2002. For

1 that twelve month period, ECMC's total collection expenses were  
2 \$8,418,986.58. During the same period, ECMC's cash collections  
3 on student loans totaled \$34,864,965.21. According to Exhibit 3  
4 and the testimony of Mr. Fisher, this would yield a collection  
5 cost of 24.15% (collection expense as a percentage of total  
6 collections), from which it calculates a "make whole" rate of  
7 31.84%. Mr. Fisher testified that the make whole rate is the  
8 rate the industry determines must be charged to the borrower in  
9 order for the holder to recover all principal and interest.

10 Mr. Fisher testified that according to the regulations  
11 applicable to student loans, NELA must recalculate the collection  
12 costs each year after a loan goes into default. As to each loan  
13 in default, the amount of the previous year's collection cost is  
14 removed from the balance of the loan and the newly calculated  
15 annual rate is applied. In addition, if payments are made by the  
16 borrower, ECMC applies a percentage collection rate to each  
17 payment and shows that amount as a payment to collection costs.  
18 For example, if the collection rate is 24.15%, as it was for  
19 2002, then 24.15% of each payment made by a borrower is applied  
20 to collection costs, the balance to interest, and then, if the  
21 payment is sufficient, to the reduction in the principal balance  
22 of the loan. Pursuant to the regulations, the collection rate  
23 must also be recalculated each time the loan is transferred from  
24 one entity to another. So, in the case of the debtors' loans,  
25 ECMC is required to remove collection costs assessed by its  
26 assignee and to recalculate and reassess those costs at the rate  
27 applicable at the time. A recalculation of the collection cost

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1 may result in an increase or a decrease of the total collection  
2 costs.

### 3 **III. DISCUSSION**

#### 4 A. Bankruptcy Code § 502.

5 Under Section 502(a), a claim is deemed allowed unless a  
6 party in interest objects to it. Section 502(b) contains a list  
7 of substantive objections that can be the basis for disallowance  
8 of a claim. The debtors in these cases challenge ECMC's proofs  
9 of claim under Section 502(b)(1), which provides for disallowance  
10 of a claim to the extent that:

11 [S]uch claim is unenforceable against the  
12 debtor and property of the debtor, under any  
13 agreement or applicable law for a reason  
other than because such claim is contingent  
or unmatured....

14 Accordingly, the Court must examine the agreement between the  
15 debtors and ECMC, as assignee, and any law applicable to the  
16 loans at issue.

17 The debtors urge the Court to hold that the collection  
18 charges are unreasonable because they do not reflect actual  
19 collection costs incurred by ECMC in enforcing collection of the  
20 debts. ECMC, on the other hand, contends that in determining the  
21 enforceability of the collection costs, the Court is bound by the  
22 federal laws and regulations governing student loans and not by  
23 the typical "reasonableness" standard the Court applies in  
24 bankruptcy cases or when examining similar charges under  
25  
26  
27

1 Washington state law.<sup>2</sup>

2 B. Enforceability Under the Terms of the Notes.

3 The debtors' student loans are governed by the terms of the  
4 promissory notes they signed. The promissory note that Ms. Evans  
5 signed on August 24, 1993, when she consolidated her student  
6 loans, is in evidence as Exhibit 15. With regard to collection  
7 costs, her note states:

8 If this loan is referred for collection to an  
9 agency that is subject to the Fair Debt  
Collection Practices Act, I will pay those  
10 collection costs which do not exceed 25  
percent of the unpaid principal and accrued  
11 interest.

12 Ms. Valdivia signed six separate promissory notes. Ex. 8,  
13 Ex. 6. Each of the notes contains a provision requiring the  
14 borrower to pay "reasonable" attorney fees and costs, but there  
15 is no percentage limitation on costs like the limitation  
16 contained in the Evans note. In addition, each note signed by  
17 Ms. Valdivia provides that it is governed by the Higher Education  
18 Act of 1965, as amended, 20 U.S.C. § 1090, *et seq.* (the "HEA").

19 C. Enforceability Under Applicable Law.

20 Student loans are generally made available to students  
21 through the Federal Family Education Loan ("FFEL") programs, 34  
22 C.F.R. § 682.1000(a), the Perkins Loan program and other  
23 subsidized loan programs. Under the FFEL programs, which are  
24 administered by DOE, loans are made to students by banks and

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25 <sup>2</sup> Note that Section 502 contains no specific ground for  
26 objection based upon a claim that the fees assessed are not  
27 "reasonable." While the reasonableness of fees is a concept  
specifically applicable under Section 506(b), that concept is not  
expressly applicable under Section 502(b)(1).

1 other private financial institutions to cover tuition, room and  
2 board and other educational expenses. Repayment of FFEL loans is  
3 guaranteed by various state and non-profit guaranty agencies. 34  
4 C.F.R. § 682.200. When a student loan borrower defaults, the  
5 guaranty agency pays the private lender. To the extent the  
6 guaranty agency is unable to collect the total amount of a  
7 defaulted student loan, the guaranty agency can make a claim for  
8 reinsurance from DOE. The terms of the loans are established by  
9 the promissory notes executed by the student loan borrowers as  
10 well as federal laws and regulations.

11 The promissory notes at issue in these cases are governed by  
12 the HEA, which provides in 20 U.S.C. § 1091a(b) that:

13 (b) Assessment of costs and other charges

14 Notwithstanding any provision of State law to the  
contrary-

15 (1) a borrower who has defaulted on a loan  
made under this subchapter and part C of  
16 subchapter I of chapter 34 of Title 42 shall  
be required to pay, in addition to other  
17 charges specified in this subchapter and part  
C of subchapter I of chapter 34 of Title 42,  
reasonable collection costs....

18 20 U.S.C. § 1091a(b) (emphasis added). The statute does not  
19 define "reasonable collection costs." Pursuant to its rulemaking  
20 authority, DOE has promulgated certain regulations implementing  
21 this provision. These regulations include 34 C.F.R. § 30.60 and  
22 34 C.F.R. § 682.410(b)(2) dealing with collection costs and other  
23 charges.

24 Under 34 C.F.R. § 30.60, delinquent student loan borrowers  
25 may be charged for costs pursuant to the formula set forth in  
26 that regulation. The collection charge assessed by ECMC and  
27

1 other guaranty agencies is governed by 34 C.F.R. § 682.410(b)(2),  
2 and is limited to the lesser of (i) the amount calculated under  
3 34 C.F.R. § 30.60, and (ii) the amount the same borrower would be  
4 charged for the cost of collection if the loan was held by DOE.  
5 The uncontroverted testimony at trial was that the debtors would  
6 be charged 25% of outstanding principal and interest if their  
7 loans were held by DOE and that ECMC's collection charge  
8 calculated under 34 C.F.R. § 30.60 would be greater than that  
9 amount. Accordingly, ECMC concedes that it is limited to a  
10 charge that is not greater than 25% of outstanding principal and  
11 interest.<sup>3</sup>

12 Based upon the evidence, the Court concludes that the  
13 collection charges assessed against the debtors are in compliance  
14 with the HEA and regulations promulgated thereunder.  
15 Consequently, the Court can invalidate the charges only if it  
16 finds that the regulations themselves are invalid.

17 D. The Validity of the DOE Regulations.

18 Under the Administrative Procedures Act, 5 U.S.C. §  
19 706(2)(A), a reviewing court must hold unlawful and set aside  
20 agency regulations that it finds to be "arbitrary, capricious, an  
21 abuse of discretion, or otherwise not in accordance with the  
22 law." The arbitrary and capricious standard of review is  
23 typically deferential to the agency. It is a narrow standard of  
24

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25 <sup>3</sup> Frankly, the Court does not understand how the rates are  
26 actually mathematically calculated under the applicable  
27 regulations. Because the debtors have not challenged the  
calculations, however, other than on reasonableness grounds, the  
Court will accept ECMC's math.

1 review and the court is "not to substitute its judgment for that  
2 of the agency." *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State*  
3 *Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43, 103 S.Ct. 2856, 77  
4 L.Ed.2d 443 (1983).

5 In reviewing an agency's regulation, the reviewing court  
6 "must consider whether the decision was based on a consideration  
7 of the relevant factors and whether there has been a clear error  
8 of judgment." *Id.* at 31. Circumstances that may give rise to a  
9 determination that an agency regulation is arbitrary and  
10 capricious include: reliance on factors which Congress did not  
11 intend for the agency to consider, failure to consider important  
12 aspects of the problem, explanations for the rule that run  
13 counter to the evidence, or the rule is so implausible that it  
14 could not be ascribed to a difference in view or the product of  
15 agency expertise. *Id.*

16 To overcome this deferential standard of review, a party  
17 challenging a regulation bears a significant burden, especially  
18 when the language used in the statute is broad. *See Educational*  
19 *Credit Management Corp. v. Barnes*, 318 B.R. 482, 486-87 (S.D.  
20 Ind. 2004).<sup>4</sup> The language at issue in the present case is the  
21 "reasonable" standard provided in 20 U.S.C. § 1091a(b) for the  
22 assessment of collection costs. This is broad statutory

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23  
24 <sup>4</sup> The *Barnes* case dealt with the identical issue in this  
25 case: whether the collection costs imposed by ECMC are  
26 reasonable. The court engaged in a lengthy analysis of the  
27 constitutionality of 34 C.F.R. § 682.410(b)(2), concluding that  
the regulation is not unconstitutional on its face or as  
administered by DOE and ECMC in the context of the bankruptcy  
proceeding at issue there.

1 language, so the debtors, who challenge the agency's  
2 interpretation in the corresponding regulation, 34 C.F.R. §  
3 682.410(b)(2), bear a significant burden.

4 Analyzing whether an agency has been arbitrary and  
5 capricious requires examining the statute's legislative history  
6 and the rule-making process. In *Barnes*, the court reviewed the  
7 legislative history and found that Congress intended that  
8 "borrowers, not taxpayers, foot the bill for costs associated  
9 with the collection of delinquent student loans." *Id.* at 489.  
10 In order to implement this goal, the DOE chose to use a cost  
11 averaging method and the formula approach set forth in 34 C.F.R.  
12 § 30.60, rather than tracking the specific costs associated with  
13 collection of a particular loan. *Id.* at 488-89.

14 The rationale behind the cost averaging method is  
15 efficiency. In *In re Schlehr*, 290 B.R. 387, 392 (Bankr. D. Mont.  
16 2003), testimony revealed that the DOE chose the cost averaging  
17 method because "it is more efficient for guaranty agencies to  
18 assess percentage-based collection costs instead of keeping track  
19 of every time they send a letter to a debtor." Further,  
20 according to the testimony, "the Secretary of Education has  
21 determined that tracking costs of collection of each defaulted  
22 loan would create too onerous of a system, that such a level of  
23 specificity would be untenable, inefficient, and that such  
24 detailed record keeping would result in far higher collection  
25 costs for debtors than percentage-based collection costs." *Id.*  
26 The *Schlehr* court concluded that "a system which track[ed]  
27 individual time and expenses for each case would be onerous and

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1 result in far higher charges to defaulting student loan debtors."  
2 *Id.* at 398.

3 As a result of Congress' concerns regarding cost, DOE's  
4 consideration of efficiency was a proper concern in the rule-  
5 making process. On the other hand, efficiency should not be the  
6 only factor that the agency considered. Indeed, the *Barnes* court  
7 noted that "care obviously must be given to assure that any  
8 disparity between the actual costs of collection and the imposed  
9 costs is kept to a minimum so that the benefits of efficiency are  
10 not trumped by unfair hardship to some borrowers." 318 B.R. at  
11 488. The court concluded that it had "no basis for concluding  
12 that the agency did not achieve such a proper balance." *Id.*

13 The arbitrary and capricious standard provides for review of  
14 agency regulations. It does not provide for review of the  
15 application of the regulation to a particular individual. In *In*  
16 *re Brown*, 310 B.R. 341 (Bankr. N.D. Ohio 2004), the court  
17 considered the fairness of the application of the regulation to  
18 individuals. In that case, the court was troubled by the fact  
19 that the collection costs appeared large in proportion to the  
20 underlying debt. *Id.* at 345. The collection costs in question  
21 ranged from \$496.66 to \$1572.78 for total student loan claims  
22 inclusive of collection costs ranging from \$2,525.52 to  
23 \$6,545.19, respectively. *Id.* at 344. While the court recognized  
24 that the collection costs seemed large in proportion to the debt,  
25 the court did not find that the costs were "facially  
26 unreasonable." *Id.* at 345. Instead, the court rationalized that  
27 student loans are risky, are made on an unsecured basis, usually

1 without regard to credit history, leaving the creditor with only  
2 the potential future earning ability of the debtor to repay the  
3 debt. *Id.*

4 In this case, the testimony was not that no collection  
5 activities had been undertaken as to any of the debtors' student  
6 loans; the testimony was that no holder of the loans made any  
7 attempt to track those collection activities or the cost of those  
8 activities. All of the loans were in default for a significant  
9 period of time prior to bankruptcy. Guaranty agencies are  
10 required to engage in certain mandatory collection action within  
11 the time frames set forth in 34 C.F.R. § 682.410(b)(6). These  
12 activities include sending the borrower written notices and  
13 commencing wage garnishments. Under the regulation, for a non-  
14 paying borrower, an agency must engage in one collection activity  
15 every 180 days.

16 The 25% collection fees assessed in these cases do not  
17 exceed amounts permitted under the applicable promissory notes.  
18 In fact, Ms. Evans' note clearly states that she could be  
19 required to pay as much as 25% of the unpaid principal and  
20 interest on the loan in the event of a default. The Valdivia  
21 notes do not contain any limit on the amount of collection  
22 charges.

23 The Court finds persuasive the reasoning employed in the  
24 *Barnes* decision, and for the reasons stated therein and in this  
25 ruling, the Court concludes that the DOE's interpretation of  
26 "reasonable" collection costs is itself reasonable and that the  
27 assessment of those costs under the circumstances of these cases

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1 does not afford a basis for disallowance of those costs under  
2 Bankruptcy Code § 502(b)(1).

3 E. The Timing of the Imposition of Collection Costs.

4 The debtors contend that the collection costs at issue were  
5 assessed by ECMC after the petition was filed, making the costs  
6 postpetition claims not subject to allowance and payment through  
7 their Chapter 13 plans. The question is answered by Bankruptcy  
8 Code § 101(5), which defines a "claim" entitled to payment from  
9 the estate broadly as follows:

10 (5) "claim" means-

11 (A) right to payment, whether or not such  
12 right is reduced to judgment, liquidated,  
13 unliquidated, fixed, contingent, matured,  
14 unmatured, disputed, undisputed, legal,  
15 equitable, secured, or unsecured; or  
16 (B) right to an equitable remedy for breach  
of performance if such breach gives rise to a  
right to payment, whether or not such right  
to an equitable remedy is reduced to  
judgment, fixed, contingent, matured,  
unmatured, disputed, undisputed, secured, or  
unsecured.

17 Under 20 U.S.C. § 1091a(b)(1), a student loan borrower becomes  
18 liable for collection costs pursuant to that statute and the  
19 regulations discussed above as soon as the borrower defaults.  
20 Under the regulatory scheme, every holder of the defaulted loan  
21 has a right to assess and recover collection charges pursuant to  
22 34 C.F.R. § 30.60 and 34 C.F.R. § 682.410(b)(2). Under these  
23 regulations, as confirmed by Mr. Fisher's testimony, the  
24 collection charges must be recalculated every time the loan is  
25 transferred from one agency to another. At the time of a  
26 transfer, the new assignee must remove any collection costs  
27 assessed by the prior holder and assess its own collection costs

1 pursuant to the statute.

2 In this case, Exhibit 14 shows that \$5,324 in collection  
3 costs had been assessed against Ms. Evans prior to the transfer  
4 of her loan to ECMC. Postpetition, ECMC recalculated that charge  
5 according to the regulations and applied the amount that is now  
6 at issue. Similarly, collection costs had been assessed  
7 prepetition against Ms. Valdivia, and those costs were  
8 recalculated postpetition by ECMC and added to the proof of claim  
9 against her. Mr. Fisher testified that costs assessed against  
10 both debtors do not include any charges for postpetition  
11 collection activities.

12 This Court concludes that the collection costs are  
13 prepetition claims against the debtors. These costs were neither  
14 unmatured nor contingent as of the petition date. They were due  
15 and payable as of the default dates on the loans, which occurred  
16 prepetition. ECMC's calculation of those costs as a matter of  
17 preparation of its claims was not an assessment of a postpetition  
18 claim; it was merely a calculation of what the debtors owed as of  
19 the petition date. Consequently, the Court also finds no  
20 violation of the stay by ECMC.

21 F. Ms. Valdivia's Right to Rehabilitation of her Loans.

22 Ms. Valdivia claims that she was denied her right to  
23 rehabilitation of her loans under 20 U.S.C. § 1078-6. The  
24 rehabilitation provisions of that statute are implemented by  
25 34 C.F.R. § 682.405. Under that regulation, a borrower in  
26 default may rehabilitate the loan by making 12 consecutive  
27 monthly payments in an amount set pursuant to

1 34 C.F.R. § 682.405(b)(1). Each payment must be received "within  
2 15 days of the scheduled due date for 12 consecutive months."  
3 34 C.F.R. § 682.405(a)(2). If those payments are made, the  
4 borrower is then eligible to have the loan returned to non-  
5 default status, is eligible for additional benefits under the  
6 applicable student loan program, and most importantly, the  
7 "collection costs may not exceed 18.5 percent of the unpaid  
8 principal and accrued interest" on the loan at the time it is  
9 sold to an eligible lender. 34 C.F.R. § 682.405(b)(1)(iv). The  
10 guaranty agency must provide the borrower with the opportunity to  
11 object to the terms of the rehabilitation agreement.  
12 34 C.F.R. § 682.405(b)(1)(v).

13 In October 2000, Ms. Valdivia negotiated for a  
14 rehabilitation of her student loans, then in default. See  
15 Ex. 18. She was to commence making 12 consecutive monthly  
16 payments of \$250 on October 28, 2000. Her first payment was made  
17 on November 1, 2000, well within the required 15 days of the due  
18 date. She testified that at that time, she set up an automatic  
19 deduction from her checking account for the required payments,  
20 and to her knowledge, all payments were paid on time. The  
21 payment history submitted by ECMC, Exhibit 7, shows that  
22 Ms. Valdivia made 12 consecutive payments from October, 2000  
23 through September, 2001. At that point, she should have been  
24 eligible for rehabilitation. Mr. Fisher had no personal  
25 knowledge of Ms. Valdivia's payment history, but believed that  
26 she was not eligible for rehabilitation because she failed to  
27 make the October 28, 2001 payment according to Exhibit 7. That

1 would have been the 13<sup>th</sup> consecutive payment, however, so that  
2 would not justify denying her rehabilitation after her September  
3 2001 payment.

4       Rather than contest NELA's determination, Ms. Valdivia  
5 recommenced making a second round of monthly payments of \$250  
6 beginning in December 2001 and continuing for a 12 month period.  
7 According to her testimony, these payments were also made by  
8 automatic withdrawal from her account and she believed that they  
9 had all been paid on time. Her payment history, however,  
10 indicates potential problems with the May and July 2002 payments.  
11 See Ex. 7. The payment history indicates a crediting of a  
12 payment in each of those months, then the cancellation of the  
13 same amount.<sup>5</sup> Evidence that her payments were all made properly,  
14 however, is supplied by Exhibit 19, which Ms. Valdivia received  
15 on or around September 26, 2002, and which acknowledged her right  
16 to rehabilitation of the loans. Ms. Valdivia testified that when  
17 she received this, she called NELA to object to the collection  
18 charges that were included in the rehabilitated loans. She  
19 believed that the collection charges had been calculated  
20 incorrectly. She never signed the Acknowledgment because she  
21 never received a satisfactory response to her objection to the  
22 charges. It appears that she continued making some \$250 per  
23 month payments after September of 2002 until the month of the

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24       <sup>5</sup> Mr. Fisher had no direct knowledge of the payment history  
25 so could not explain the notations in Exhibit 7, except to  
26 speculate that perhaps these represented bad checks. That would  
27 not explain the notations, however, if Ms. Valdivia's payments  
were being made through automatic deductions from her checking  
account.

1 bankruptcy filing. See Ex. 7.

2 Based upon the evidence, the Court concludes that  
3 Ms. Valdivia's loans should have been eligible for rehabilitation  
4 as of September 2001. ECMC, as the assignee of the Valdivia  
5 Loans from NELA, has the burden of proving she was not eligible,  
6 and ECMC has not met that burden. Accordingly, the Court will  
7 require that Ms. Valdivia be given the option to treat the loans  
8 as eligible for rehabilitation as of October 2001. If she agrees  
9 to rehabilitation as of that date, then the collection costs  
10 assessed against her may not exceed 18.5% of the principal and  
11 interest outstanding as of October 1, 2001.<sup>6</sup>

12 **CONCLUSION**

13 Accordingly, the Court will enter an order denying the  
14 debtors' objections to ECMC's claims in these cases, except that  
15 Ms. Valdivia will be deemed eligible for rehabilitation under  
16 34 C.F.R. § 682.405 as of the petition date in her case; and if  
17 she elects to rehabilitate her loans, ECMC's proof of claim must  
18 be amended to reflect the new terms.

19 DATED this 21<sup>ST</sup> day of March, 2005.



20  
21 KAREN A. OVERSTREET  
UNITED STATES BANKRUPTCY JUDGE

22  
23 <sup>6</sup> The Court notes that it is difficult to determine whether  
24 Ms. Valdivia will actually be better off if the loans are treated  
25 as rehabilitated, because the regulations permit the collection  
26 fees to be capitalized; and going forward, the new principal  
27 balances, including the collection costs, will bear interest. In  
the absence of rehabilitation, according to the testimony of Mr.  
Fisher, although interest on a defaulted loan may be capitalized  
annually, ECMC would not be able to capitalize the 25% collection  
costs. The Court will leave it to counsel for Ms. Valdivia to do  
the math.